WestNetRail

13 May 2011

Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

Attention: Senior Project Officer - Access

Dear Sir or Madam

WNR Submission on the ERA's "Review of the Railways (Access) Code 2000 – Draft Report"

Introduction

This submission sets out WestNet Rail's (WNR) response to the Economic Regulation Authority's (ERA's) draft report on the review of the *Railways (Access) Code 2000* (the Code).

Firstly, WNR responds specifically to the proposal to replace the existing gross replacement value (GRV) cost determination methodology with a 'Building Block' approach, which is contained in Recommendation 6 of the Draft Report (the Proposal), as follows:

> "Unless it can be demonstrated that the Building Block approach could cause an inefficient calculation of ceiling costs, clause 2(4) should be amended to prescribe a Building Block approach to the determining of costs, in place of the current GRV based approach."

As noted in our January 2010 submission on the ERA's issues paper, the purpose of the review is to assess how effective the Code has been in meeting the objectives of the Competition Principles Agreement (CPA). In this regard, WNR would expect changes to be made to the Code only where there is compelling evidence that the existing provisions are not effective in meeting CPA objectives. Where the ERA recommends changes to the Code, WNR expects that these changes will be fully explained and their ramifications assessed, so that it is shown that they will demonstrably improve the effectiveness of the Code in meeting CPA objectives.

WNR is disappointed with the manner in which the ERA has introduced the Proposal. In particular, WNR has concerns with the process being followed by the ERA in developing the Proposal, and considers that it is highly likely to be contrary to WNR's legitimate business interests.

The WA access regime provides for light handed regulation which strongly encourages commercial negotiation between the parties, while providing mechanisms to ensure that this occurs within economically reasonable boundaries. The GRV based floor and ceiling price is an important protection to access seekers and as such forms a key element of these boundaries.

WestNet Rail Pty Ltd, ABN 42 094 721 301
T +61 8 9212 2501 F +61 8 9212 2922 E info@wnr.com.au 2-10 Adams Drive, Welshpool WA 6106 GPO Box S1411, Perth WA 6845
www.wnr.com.au

The WA access regime provides for light handed regulation which strongly encourages commercial negotiation between the parties, while providing mechanisms to ensure that this occurs within economically reasonable boundaries. The GRV based floor and ceiling price is an important protection to access seekers and as such forms a key element of these boundaries.

The consistency of the WA access regime with the CPA objectives has already been accepted, with the National Competition Council's (NCC) recent recommendation that the WA rail access regime should be certified in accordance with the Trade Practices Act. Further, with regard to the CPA objectives, the regime has so far not proven to be materially deficient, as evidenced by the substantial growth in freight volumes on WNR's network and our ongoing investment in the network.

WNR considers that an important element in achieving these outcomes has been its confidence in the stability of the WA access regime. Sudden and unexplained changes to the regime, such as the proposed change to the GRV approach, will reduce confidence in the regime and will undermine the very effectiveness of the regime that the Review is designed to enhance.

ERA Process in Developing the Proposal

The requirement for the ERA's review of the Code is established in section 12, Part 2 of the *Railways (Access) Act 1998* (the Act). The Act specifies that the purpose of the review is to assess the suitability of the provisions of the Code to give effect to the CPA in respect of the railways to which the Code applies.

Section 20(4) of the Act sets out a range of factors that the ERA must take into account in performing its functions under the Act or the Code which includes, amongst other things, the railway owner's legitimate business interests and investment in railway infrastructure.

WNR makes the following observations regarding the Proposal:

- The Proposal is likely to have a serious, adverse impact on WNR's financial interests, as discussed further in the next section of this submission. Of the affected rail infrastructure owners, WNR is arguably the most exposed to the impact of any change to the GRV methodology.

- The ERA is required to seek public comment on any proposed amendments to the Code. The Proposal was not directly canvassed in any detail in the Issues Paper which invited public comment. Similarly, the detail and content of the building block methodology is not described in the Draft Report. Accordingly, WNR has had no opportunity to consider the implications of the Proposal or prepare a detailed response.

- The ERA has stated that the building block methodology should be adopted unless it can be demonstrated that it would cause an inefficient calculation of ceiling costs. WNR is surprised by this position as it could be interpreted as indicating a closed and pre-determined approach. This stance incorrectly attempts to reverse the onus for justifying the Proposal. It is the responsibility of the ERA to justify why this change is required; it should not be for the public to have to rebut it without the ERA providing full explanation and proper justification of the Proposal.

- There is no indication in the Draft Report of the unsuitability of the present provisions relating to the GRV methodology to give effect to the Competition Principles Agreement. This is the primary purpose of the ERA's review of the Code. WNR notes that there is no analysis whatsoever as to whether or not the GRV approach generates an efficient result – the ERA simply appears to assume that it does not (a contention that WNR refutes as we are not aware of any evidence that the GRV approach in fact produces an inefficient result). WNR further contends that there is nothing inherently optimal about the building block approach (which is discussed in more detail later in this submission) and reiterates its previous submissions concerning the arrangements that can be made to ensure future capex is properly captured for the purposes of future GRV determinations.

- There is no explanation in the Draft Report regarding how the ERA has taken into account the factors detailed in section 20(4) of the Act in drafting the Proposal.

Accordingly, WNR is concerned about the process that the ERA has followed in making the Proposal, and whether it has in fact granted WNR a proper hearing in relation to this matter.

Impact of the Proposal on WNR's Legitimate Business Interests

Given the absence of detail on the ERA's intended building block approach, it is simply not possible for WNR to assess the implications of the Proposal for its business. Nevertheless, acknowledging the possibility that the ERA may not grant WNR (or other parties) another opportunity to comment on the Proposal, we make comment on the building block approach below, but once again reiterate that insufficient detail has been made available in the Draft Report for anything other than speculation.

Based on the way in which building block approaches have been used in regulated industries elsewhere in Australia, including in relation to rail networks, WNR considers that there is a high likelihood that a building block approach would have a serious adverse affect on its financial interests.

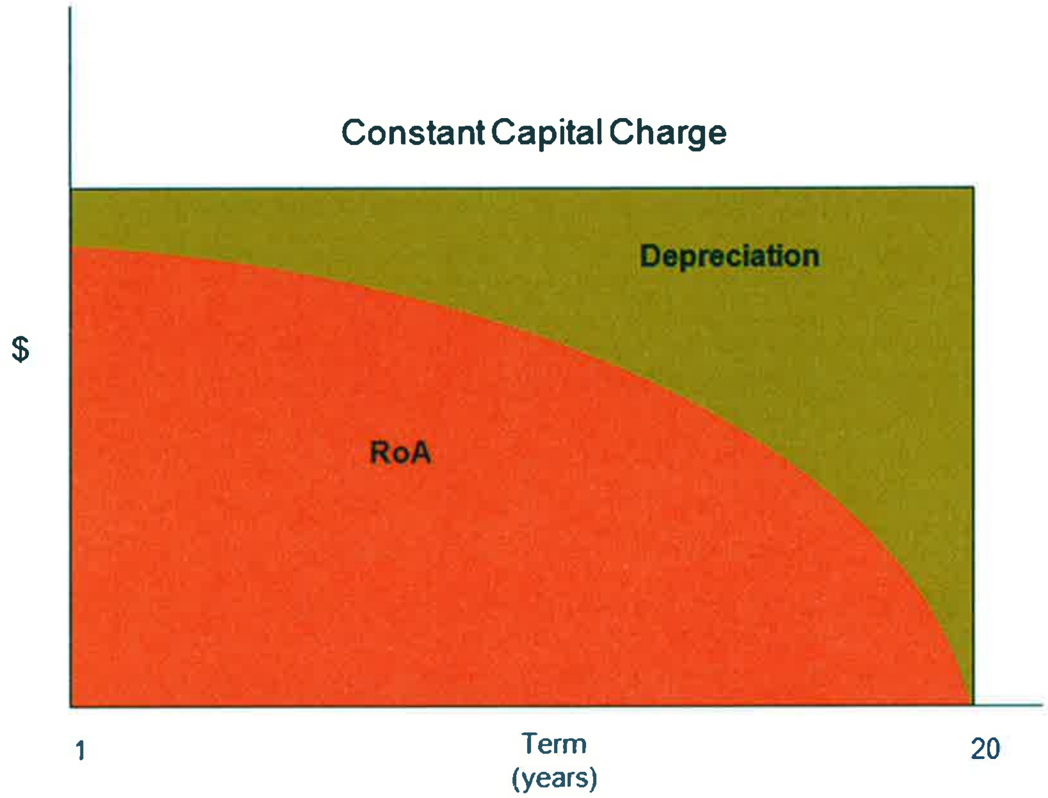
GRV Approach

The GRV approach established in the Code provides for ceiling prices to be determined, at a particular point in time, to reflect the total costs of providing the service, where the total costs include:

- Capital costs, being the annual, or annuity, cost of the assets used to provide the service, where the annuity is determined using the current gross replacement value of the assets as the principal, the WACC as the interest rate and the economic life of the assets as the term; and

- Operating costs, including maintenance, other operating costs and overheads, incurred in providing the service.

The GRV based capital cost component essentially includes a return on assets component (based on WACC) and a depreciation component. However, in order to simplify the assessment of the capital costs, it is determined so that, over the life of the asset, the sum of the return component and the depreciation component remains constant. In effect, the depreciation profile is modified to achieve this by "backending" the depreciation. WNR notes that this depreciation profile reflects the asset consumption for an asset providing a constant level of service over its life. This is demonstrated in the figure below:



Building Block Approach

The ERA has not provided any detail about how it would intend to apply a building block methodology. However, some general observations can be made about how building block methodologies are used elsewhere in Australia.

What is a Building Block Methodology?

In its simplest terms, a building block methodology is one where the price is determined through the summation of the cost components of providing the service, including:

- Capital costs, being the depreciation and return on assets (based on WACC) applied to the value of the assets used to provide the service; and
- Operating costs, including maintenance, other operating costs and overheads, incurred in providing the service. Tax expenses will also be included, provided that WACC is determined on a post tax basis.

Arguably, the GRV approach used in the Code is a form of building block methodology, but one where the depreciation on the assets achieves a consistent capital cost over the life of the asset, rather than an estimate of the physical or economic depreciation of the asset.

A building block approach can either be used in a philosophical way to assess a ceiling price at a given point in time (as currently occurs in the Code), or in a prescriptive way in order to determine a regulated price.

Prescriptive Building Blocks Methodology

The prescriptive building block methodology typically used in access regulation is one where access charges are determined for the regulatory period (being one or more years) based on the forecast building block values. In particular, the prescriptive building block methodology is typically based on a Regulatory Asset Base (RAB) which is initially determined by the regulated business and endorsed by the regulator, and which is then "rolled forward" each year based on prescribed rules:

	Opening RAB
Plus	Capital Expenditure
	Asset Appreciation (CPI)
Less	Depreciation
Equals	Closing RAB

The access charges determined under the prescriptive building block methodology are strongly influenced by the opening asset value of the regulated assets. The methodology used to determine the opening RAB is typically:

- for existing assets, the Depreciated Optimised Replacement Cost (DORC) asset valuation methodology; and
- for new assets, the actual cost of construction.

Various approaches may be used to assess depreciation (both for the purpose of assessing the initial DORC valuation and for assessing annual depreciation thereafter), but the most common approach used is straight line depreciation.

The way that the prescriptive building block methodology is applied to specific regulated businesses can vary significantly in terms of matters such as:

- depreciation methodology used;
- whether, and if so how, to deal with variations between forecast and actual capital expenditure;
- whether, and if so how, to deal with circumstances where actual revenue earned is less than the building block assessment.

When is the Prescriptive Building Block Methodology Typically Used?

A prescriptive building block methodology is currently used for a number of regulated infrastructure businesses in Australia, including electricity, gas and some rail infrastructure. However, the key elements that these businesses typically have in common are:

- they are charging at or near the ceiling price and are subject to close regulatory oversight of their access charges; and
- they are investing heavily in new infrastructure and they require confidence that they will get this investment returned in a manner and timeframe acceptable to their financiers.

Looking specifically at the way that the rail industry is regulated in Australia, it becomes clear that, while building block approaches are often used, there are significant differences in the way they are applied:

- for the heavily utilised coal networks in Queensland and NSW, a prescriptive building block methodology based on a detailed RAB is used;
- for the interstate rail network, a building block methodology is used to assess whether the indicative prices specified in ARTC's access undertaking are less than the ceiling, but there is no concept of a detailed rolled forward RAB; and
- where a building block methodology is applied to lightly trafficked networks (e.g. Queensland Rail and ARTC's regional NSW network), this is typically used in a philosophical sense only, to test compliance with ceiling prices as required.

Potential Impact of Applying Building Block Methodology to WNR

Unfortunately, the ERA has not provided any specific detail about how a building block methodology would be incorporated into the Code. As a result, it is simply not possible for WNR to assess the ramifications of moving to a building block approach. The impacts are likely to fall into a number of categories:

Valuation

If the RAB was to be initially based on a DORC valuation method, this would result in a substantial reduction in the valuation of WNR's infrastructure assets for the purpose of assessing the price ceiling. There is also the risk that the roll forward methodology may not reflect real increases in construction costs, as has occurred in other regulatory regimes.

Regulatory burden

A requirement to maintain a RAB for the WNR network would create a significantly increased administrative cost for WNR, as the result of:

- the need to identify a construction date of all existing assets;
- the need to identify a record of the current depreciated value of each asset for regulatory purposes;
- the need to maintain the record of depreciated values for each asset for regulatory purposes and to implement an approach to rolling forward the regulatory asset base;
- the business requirement be able to reconcile the regulatory asset values with the asset values used for financial reporting;
- the need to develop a new ceiling price model; and
- the need to identify and to develop (with the ERA) the approaches for dealing with specific implementation issues in the WNR context (and the attendant risks that this creates for WNR that these approaches will not be accepted by the regulator).

Perceived Regulatory Risk

The GRV approach has been a fundamental plank of the WA access regime and has been the foundation for WNR's assessments of the valuation of its business as well as the risks and opportunities associated with capital expenditure. Such a fundamental change to the regulatory regime, particularly with such limited consultation, will increase the regulatory risk of WNR's business. Increased regulatory risk will undermine WNR's confidence to further invest in its WA rail network.

ERA's Justification for the Proposal

As noted earlier, the ERA has provided minimal explanation of its reasons for this recommendation. The ERA has not identified any systemic failure in the existing access regime to support this change. The specific factors mentioned by the ERA as benefits of the change are discussed below.

Need to Incorporate Forecast Capital Expenditure

The ERA has identified as a benefit the ability for the building block approach to allow forecast capital expenditure to be incorporated in a cost determination. WNR considers that there are a number of options, apart from the adoption of a prescriptive building block approach, that could be used to achieve this, including (but not limited to):

- modifying the GRV framework to include mechanisms to deal with new investments as initially suggested by the ERA in its Issues Paper; or

- as suggested by OPR, allowing infrastructure owners the option of the existing GRV framework or a DORC based building block approach.

In the interest of accommodating forecast capital expenditure within the regime whilst not undermining the legitimate business interests of railway owners affected by the regime, WNR strongly believes that the ERA needs to explicitly identify and consider the full range of options that may be available.

Consistency with Other Jurisdictions

The ERA has noted that a benefit of the building block approach may be administrative improvements by unifying the approach under the Code with that applied to other railway networks in Australia.

WNR questions the validity of this benefit. The WA Government noted, in its application to the NCC for certification of the WA rail access regime, that as part of the Council of Australian Governments (COAG) process, it was agreed that a consistent system of rail access regulation (based on the ARTC model) should be implemented for all nationally significant rail corridors, *where the benefits of such consistency exceeded the costs* (emphasis added) [1]. As highlighted in this application, given that ARTC has described the WA Access Regime as "in many areas broadly consistent with similar provisions incorporated in the ... undertaking", it is questionable whether changing the WA access regime would deliver a net benefit [2]. It is clearly apparent that the WA Government intends that any changes to the WA regime for the purpose of improving national consistency should only occur where there is a demonstrable net benefit of doing so.

WNR considers that the benefits of national consistency in the methodology for determining ceiling prices will be minimal.

---

1 Certification of the Western Australian Rail Access Regime Submission to the National Competition Council, The Government of Western Australia, May 2010, p11

2 Ibid.

Way Forward

WNR considers that the ERA needs a specific, detailed consultation process in order to progress this issue. WNR requests that the ERA revoke its recommendation regarding the Proposal in its Final Report.

WNR remains open to engage with the ERA to consider improvements to the GRV methodology. The steps that such an approach might involve include:

- the ERA explaining why the GRV methodology is not suitable to give effect to the CPA;
- WNR and ERA (together with other stakeholders) identifying and analysing the options for addressing the identified concerns with the GRV methodology, particularly in relation to forecast capital expenditure;
- the ERA explaining in detail what is meant by the building block methodology and why it considers a building block methodology to be the most suitable option;
- the ERA explaining how any future recommendation (regarding this or any other change to the Code) addresses the factors detailed in section 20(4) of the Act. In particular, the Authority should state how it has taken into account railway owner's (including WNR's) legitimate business interests and investment in railway infrastructure; and
- the ERA granting WNR, and other stakeholders, a sufficient right to be heard in relation to the detailed content of any future proposal concerning ceiling prices once the above information has been provided.

Unless the ERA follows such a process, WNR cannot support any changes to the GRV methodology, on the basis that it is unable to assess the effect of any change.

In the unfortunate event that the ERA does not exercise greater public engagement on this matter, WNR notes that we are entitled to directly advise the Minister of our concerns, particularly with regard to obligations imposed on the ERA, and rights bestowed upon WNR, by the Act.

Additional Commentary on the Draft Report and Recommendations

WNR also makes comment on the following recommendation in the Draft Report:

Recommendation 6

Schedule 2 should be amended as follows:

- Clause 4(g) "the running times of existing trains" should be replaced with "relevant running information for all current scheduled trains or cyclical train movements, as appropriate".

WNR does not support this change. In its submission on the Code Review Issues Paper of October 2009, WNR strongly opposed any requirement to publish capacity information. Then, as now, we argued that there is no capacity metric that can be published which provides meaningful information to access seekers. Capacity is dependent on the nature of the task the access seeker is requesting, as well as the ability of the railway owner to manage and optimise the network task.

It is WNR's belief that the provision of the information proposed in Recommendation 6 should be opposed with similar arguments. It is not possible for an access seeker to exercise the network specific management and optimisation tasks essential in the formulation of a realistic operational plan. As an example, the specific running information for existing scheduled trains can be substantially different to the running information of those trains after a new access request has been incorporated into the network task. This stems from the railway owner's ability to manage the existing network task in order to accommodate a new task – an ability the access seeker does not possess.

The Code contemplates a situation where the access seeker makes no reference to the detailed day-to-day operational knowledge and abilities of the railway owner, where in reality, it is likely to be the railway owner who will provide the skills and knowledge to formulate a successful operating plan once an outline of the proposed task has been formulated by the access seeker. WNR believes that Recommendation 6 above presumes an access seeker's ability to construct a realistic operating plan without the assistance of the railway owner.

In addition, WNR has concerns about matters of confidentiality with regard to train path allocation, as well as physical network security. With the existence of a publically available, easily accessible list of train schedules, it becomes a trivial task to work out which customer's trains are running at which locations at each time of the day. Although none of this is secret information, the difficulty in acquiring it currently offers some security with regards to these concerns.

To reiterate, WNR does not support the aforementioned part of Recommendation 6. The items in Schedule 2 of the Code currently provide an access seeker with enough information for them to make an informed proposal with regard to the physical compatibility of the network with above rail assets, as well as a theoretical 'ideal case' operating plan with regard to network capacity. An operational plan that could be realistically implemented could only be developed in a cooperative fashion between the access seeker and the railway owner, where both parties are seeking the common goal of more traffic on the network and where both parties can simultaneously achieve their respective objectives.

WNR values the opportunity to work together with the Authority, to ensure its review of the Code achieves the best result for owners and users of rail infrastructure in Western Australia.

Yours faithfully

Paul Larsen
Chief Executive Officer
WESTNET RAIL